

THE COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATION AND ENERGY

Investigation by the Department of Telecommunication)
and Energy on its own Motion into the Pricing and) D.T.E. 99-60
Procurement of Default Service Pursuant to G.L. c. 164, §1B(d))

REPLY COMMENTS OF
THE COMMONWEALTH OF MASSACHUSETTS
DIVISION OF ENERGY RESOURCES

July 28, 1999

I. EXECUTIVE SUMMARY

The initial comments submitted in response to the Department of Telecommunications and Energy's Order Instituting a Notice of Inquiry / Generic Proceeding into the Pricing and Procurement of Default Service, D.T.E. 99-60, reflect a strong potential for consensus regarding essential aspects of a policy framework for default service ("DS"). The Commonwealth of Massachusetts Division of Energy Resources ("DOER") looks forward to ongoing discussions among stakeholders to forge a consensus in those areas that evidence a commonality of views, and to further efforts to resolve those few areas where participants have expressed different ideas. DOER is optimistic that stakeholders can come to agreement regarding the policy framework for DS, then move swiftly to aid the Department in developing an implementation plan for a new approach to the pricing of DS in the Commonwealth.

II. OVERVIEW

The initial comments submitted by participants in this docket bode well for the future of default service and for competition in Massachusetts. The Department of Telecommunications and Energy ("Department") has received thoughtful comments from those representing the spectrum of stakeholders in the emerging competitive electricity market in Massachusetts. The Division of Energy Resources observes that a large degree of consensus is emerging on the basic policy framework for DS. DOER is optimistic that further discussions among participants focusing on the few remaining issues will produce

a comprehensive policy framework for DS that is fully consistent with fundamental policy objectives for restructuring in the Commonwealth.

Clearly, additional steps beyond the formulation of the underlying policy framework will be necessary before a detailed implementation plan for new DS pricing is finalized. However, DOER is confident that, if the spirit of cooperation among stakeholders that has been evidenced throughout the restructuring process is preserved, resolution of the mechanics of DS implementation and other "details" of a DS implementation plan can occur expeditiously. The time is right to advance to a result that will truly benefit consumers and the other stakeholders in Massachusetts' electric industry.

III. AREAS OF CONVERGENCE AMONG COMMENTERS

DOER's optimism is not unfounded. Comments submitted to the Department in this proceeding reflect a large degree of consensus regarding the essential parameters of DS. This consensus is revealed through a review of commenters' responses to questions raised by the Department in its NOI. DOER observes that a significant majority appear to agree on the following:

- **It is time to change the way default service is priced in Massachusetts.** Nearly all commenters indicate that the time has come to re-evaluate the way in which DS is priced in Massachusetts.
- **Rates for DS should reflect the costs, whether "wholesale" or "retail," incurred in providing this retail service to customers.** Nearly all commenters agree, in concept, that DS pricing should reflect all of the costs of making the service available to customers.
- **DS rates should include, among other things, the costs of a DS generation supply acquired on an "all-requirements" basis.** The generation supply for DS should be acquired through competitive solicitations, in keeping with statutory requirements. Most suggest that the DS rate should reflect (1) the actual per kWh cost of a commitment from a DS generation supplier to provide an "all-requirements" DS generation supply at a uniform rate across a six-month period, and (2) the other costs incurred in bringing that supply to DS customers. As noted below, commenters express different views as to the other costs to be included in that latter category.

- **Specifying an "average monthly market price for electricity" is currently difficult or impossible.** Various commenters provided a number of compelling reasons as to why, at this stage of development of the emerging electricity markets (wholesale and retail), it would not be appropriate seek to tie DS rates to prices in ISO New England's spot markets, or to other possible market indices or benchmarks.
- **It is not necessary to immediately change base rates in order to move generation costs from the distribution component of customers' bills to the generation component of customers bills.** This issue was addressed most directly by those who advocate DS rates that provide proper price signals to retail suppliers by reflecting a measure of the costs incurred by distribution companies in providing DS. Some explain that the additional revenues resulting from DS rates above the DS generation supply costs could be credited to all customers of a distribution company to avoid "double billing" or conflicts with distribution rates freezes.
- **Competitive solicitations for DS should occur semiannually.** A DS generation supplier would be required to provide a generation supply to all eligible customers during a six-month period.
- **The approaches that other states have taken to DS are not directly transferable to the Massachusetts restructuring framework.** However, activities in other states offer insights into the issues to be addressed in establishing a DS policy.

These views represent a strong consensus. They represent a good solution to many of the essential issues that must be addressed in establishing a DS policy framework. This achievement -- and the present opportunity to proceed with a spirit of cooperation among participants -- establish a solid foundation for resolution of the few remaining key policy issues outlined below.

IV. DOER's THOUGHTS ON THE ISSUES REQUIRING FURTHER ATTENTION FROM STAKEHOLDERS

Despite the convergence in thinking on the conceptual framework for default service, there were several areas where different approaches have emerged, or where important ideas have been addressed by only a few. In the remainder of these reply comments, DOER focuses on the four areas that warrant further consideration by the participants in this proceeding: (1) the cost components to be recognized in the DS rate, (2) continuing service to DS customers, (3) whether there should be multiple DS pricing and service options, and (4) whether any single distribution company should be permitted to engage multiple suppliers of DS generation services.

A. Cost Components of the DS Rate

A consensus has emerged that the DS rate should incorporate the costs incurred in obtaining the generation supply necessary to support DS. However, as noted in Section II above, commenters have expressed different views regarding the "other" costs that should be included in the DS rate to have it reasonably reflect "all" costs incurred in providing the service to retail customers. Several distribution companies suggested that the DS rate should include only the costs that a distribution company would have to pay to a DS generation supplier for "all requirements" service. See e.g., Cambridge, Commonwealth, Boston Edison Combined Comments at 4; Eastern Edison Comments at 7; Fitchburg Gas and Electric Comments at 2,4; Western Massachusetts Electric Comments at 2. These might include the costs of the seven electricity products traded in ISO New England's spot markets (whether acquired from those markets or through bilateral contracts), transmission and other charges from ISO New England (including any transmission congestion costs, ancillary service costs, locational and system support costs, and transmission losses), and the distribution losses that distribution companies would typically assign to competitive suppliers. Presumably, the fixed, per kWh bid price offered by a prospective DS generation supplier would support costs to acquire and manage a supply portfolio, match supply to the load shape, manage price load and price risk, provide working capital and necessary administrative services, and cover any other related costs incurred by the supplier.

Other commenters recommend going a step further to ensure that an appropriate share of the costs that a distribution company incurs to support DS are identified and included with the DS generation supply costs in framing DS rates. See e.g., Attorney General Comments at 2; DOER Comments at 17; Massachusetts Electric Comments at 6; Western Massachusetts Industrial Customers Group Comments, App. A at 3; IRATE Comments at 2-3. Costs incurred by a distribution company to support DS might include DS program administration costs, credit, collection and bad debt costs, an allocated share of a company's general and administrative expenses, and customer support costs (including metering, billing, and customer information management costs).

Finally, some commenters suggest that the DS rate should incorporate an additional adjustment to reflect all costs that competitive suppliers, marketers and brokers selling electricity at retail might be expected to incur. Most notable among these are the marketing and other costs that might be incurred in attracting customers to a given competitive supplier's service. Those who support this approach to identifying appropriate DS rates assert that these costs must be factored into the DS rate if Massachusetts is to have a competitive retail electric market. See e.g., Joint Comments of AllEnergy Marketing Company, L.L.C., et al at 19.

DOER has recommended that the DS rates reflect all costs that a distribution company would incur in making DS available to customers. These would include the cost of acquiring a DS generation supply and the costs incurred by a distribution company as assigned on a fully allocated cost of service basis. As indicated in DOER's initial comments, this result could be readily achieved by requiring distribution companies to

charge DS generation suppliers for services provided by a distribution company according to a schedule established in an RFP for DS generation supplies. The incremental revenues received by distribution companies would be returned to all ratepayers through distribution rate credits, ensuring appropriate cost recovery for distribution companies, without over- or under-collections.

DOER submits that this represents the best construct for DS rates. Because this approach will ensure that the DS rate will reflect all costs incurred in delivering a generation product to retail customers, DS rates will be established at a level against which competitive suppliers can compete on a "level playing field." DS customers will enjoy the benefits of a mechanism that promotes rates at the lowest possible level because only suppliers that can (1) beat the retail costs of the distribution utility as a large load aggregator, or (2) offer consumers a better value through alternative pricing and service options, will be able to draw customers from DS. DOER concurs with the Attorney General's observation that this approach would "avoid any unfair cost advantage for DS as well as ensure that erstwhile competitors succeed only to the extent that they offer a real economic advantage over centralized buying." Attorney General Comments at 5-6.

Using established methods of cost allocation to address a distribution company's contribution to default service represents an imperfect, but appropriate method for valuing related services. Failure to recognize these costs would be to provide a hidden subsidy to DS customers, as compared to the costs incurred by other retail suppliers that might seek to serve them. Moreover, allowing costs incurred to support DS to remain hidden in base rates may largely remove incentives for distribution companies to strive to limit the magnitude of these costs (even if they derive from assets-in-common with other regulated and/or unregulated services). Allocating all costs that are directly and indirectly incurred by distribution companies in providing default service will ensure that DS prices reflect a true retail rate. Other retail suppliers -- all of which will be aggregators of load, large and small -- can and should compete against the "all in" retail rate offered by a distribution company acting as a load aggregator.

DOER expects that the future electricity market may contain national load aggregators serving loads that are much larger than those represented by the default service load of any Massachusetts distribution company. The rates at which national retailers are likely to compete could exhibit scale economies such that the allocated share of their costs to support retail sales will be much smaller than the allocated share of costs to support DS likely to be identified by Massachusetts distribution companies. By ensuring that DS rates offered by distribution companies include an appropriate allocation of costs, retail competition will expand as large load aggregators bring true price savings to DS customers and other retail suppliers offer products and services that otherwise enhance value to DS customers.

B. Continuing Service to DS Customers

DOER and the eleven retail suppliers who submitted joint comments addressed the issue of the periods during which customers might be able to remain on DS. DOER Comments

at 19; Joint Comments of AllEnergy Marketing Company, L.L.C., et al at 11. In keeping with the initial formulations of DS offered by the Department in Docket 96-100, at 139 (December, 1996), DOER maintains that there are powerful public policy reasons to ensure that DS is cast as a temporary, safety net service that encourages customers to take advantage of the competitive market for electricity. DOER views this issue as pivotal in this inquiry -- its resolution will determine the speed and vigor with which a fully competitive retail market for electricity emerges in Massachusetts.

DOER strongly recommends that the Department adopt a mechanism whereby, when a customer comes to the end of a predetermined term of DS (DOER suggested in its Initial Comments that this term should be six months), any DS customer that has not made an election to continue receiving DS or made a competitive supply election would, with ample notice, become a competitive customer of the DS generation supplier. So long as the rules for DS provide for any customer to readily choose to remain on or easily return to DS, government will be providing appropriate protection for vulnerable or purposefully passive customers. Put more simply, customers who wish to remain on DS indefinitely should affirmatively elect to do so for each period after their first period on DS. Without such mechanism, DS could easily become a permanent "resting place" for many customers whose inertia would dampen retail competition and deprive them of its benefits.

DOER is convinced that, with proper notice provisions to customers and no substantial barriers to returning to DS, a mechanism that moves DS customers into the competitive market will benefit customers individually and collectively. This feature would encourage more suppliers to participate in DS generation supply solicitations, and would provide strong incentives for suppliers to aggressively bid for DS contracts. Because DS prices will be driven to the lowest possible levels and all customers would have a ready ability to choose DS rates, competitive suppliers of electricity will be challenged to forge electricity products that truly bring additional value to customers in a newly vitalized retail market.

C. Multiple DS Options

Third, some commenters suggested that customers be permitted to select among two or more rate options under a DS umbrella. Such options might include a six-month DS rate, a rate that varies monthly, or rates that vary outside of other time frames less than six months. See e.g., Associated Industries of Massachusetts Comments at 2-3.

DOER sees several potential problems with this proposal. First, as the Department suggested in its Order in D.P.U. 96-100, at 74-75 (December 1996), the best way to eliminate concerns that distribution companies might exercise vertical market power is to eliminate them from the generation supply business. Distribution companies offering an array of products under the auspices of DS would bring a return of the concerns that have been largely allayed with the recent string of generating unit divestitures. DOER agrees with Massachusetts Electric Company's observation that DS should not be seen as an

avenue for distribution companies to reenter the retail electricity sales business. Massachusetts Electric Comments at 5.

Second, at a practical level, some service must be the true default. That is, when a distribution company is confronted with a customer that is drawing electricity from a distribution system, but lacks a supplier, some specific rate must be identified to charge the customer for electricity consumed. Unless the distribution companies are to be left to make arbitrary choices regarding which of their DS rates a given customer is to be assigned to, a single DS must be identified as the true default. Within this context, the availability of "other" DS options quickly begins to appear as a set of competitive products offered by a distribution company. These other DS options would detract from the ability of competitive suppliers to offer similar, if not identical options to customers.

D. Multiple DS Generation Suppliers

Some commenters suggested that each distribution company should engage multiple DS generation suppliers. The objective would be to ensure that no supplier gains an undue advantage in the market. See e.g., Associated Industries of Massachusetts Comments at 3. By contrast, Cambridge, Commonwealth and Boston Edison suggest that a single, statewide RFP for a DS generation supply be considered. Cambridge, Commonwealth, Boston Edison Joint Comments at 5.

DOER appreciates the concern that, through DS, a single competitive supplier might capture a dominant share of the retail electricity market in Massachusetts. Consequently, DOER is currently opposed to a single, statewide solicitation for a DS generation supplier. Nonetheless, DOER believes that the proposal to divide DS among a number of DS generation suppliers in a single service territory could be problematic. First, a single large load aggregator is preferable because it is likely to capture economies that would permit it to offer a DS supply rate that is cheaper than the DS supply rates that might derive from several somewhat smaller suppliers. Second, allowing multiple "winners" in a DS generation supply solicitation would lead to challenges in setting the DS rate. For example, in order to ensure a single DS rate, it would seem that all winners would be permitted to enjoy the high bid price -- which could be seen as artificially and unnecessarily increasing the cost of DS. Third, if only a handful of suppliers routinely participate in DS generation supply solicitations, the promise of multiple winners may diminish pressure on prospective suppliers to minimize bid prices. For these reasons, DOER is reluctant to embrace the proposal for multiple DS generation suppliers within a single distribution company's service territory.

DOER believes that it may be necessary for the Department to review this question periodically on an ongoing basis. That is, the solicitations for DS generation supplies issued by the first few Massachusetts distribution companies should anticipate only a single winner would result. As experience is gained with DS generation supply solicitations, information will emerge regarding both the entities willing to participate in DS generation supply solicitations and the results of the initial solicitations. Using that information, it may be appropriate for the Department to ensure that subsequent

solicitations strike a reasonable balance between minimizing DS rates and promoting a reasonable number of DS generation suppliers in the market.

IV. CONCLUSION

DOER has advanced a detailed proposal for a default service policy framework. DOER's proposal would achieve important policy goals while advancing a position that is consistent with the emerging consensus among stakeholders. DOER recommends the following:

- The Department should change the way that DS is priced, as soon as is reasonably possible.
- Rates for DS should reflect the costs, whether wholesale or retail, incurred in providing the service to ratepayers.
- DS rates should include, among other things, the costs of the generation supply for DS customers procured by each distribution company under "all-requirements" contracts.
- DS rates should not be tied to ISO New England's spot market for electricity or to other "benchmark" prices, at least for the present.
- The Department should institute a credit mechanism to ensure that DS revenues above the costs incurred by a distribution company in procuring a DS generation supply are returned to all ratepayers so as to avoid "double billing" and preserve the competitive price signals established by DS rates.
- DS generation suppliers should make their supply available to all "comers" across a six-month period.
- DOER is not aware of any approaches to DS that have been adopted in other states that would be transferable to Massachusetts.

DOER's proposed default service policy also advances solutions to each of the four outstanding issues in the design of a DS policy framework:

- DS rates should include an allocated share of the costs incurred by distribution companies in making the service available to customers.
- At the end of a six-month DS term, customers should continue to be served by their DS generation supplier as competitive customers.
- DS should encompass only a single product, rather than several DS options.

- Each distribution company should engage a single DS generation supplier, subject to ongoing monitoring by the Department.

DOER looks forward to a discussion with the other participants in this proceeding in an attempt to forge a consensus on the outstanding issues regarding the DS policy framework. Once this critical phase is complete, we anticipate swift action to support the Department's efforts to establish specific mechanisms for the implementation of DS in a manner that will promote uniformity for customers, distribution companies and DS generation suppliers. DOER is confident that final steps can soon be taken to complete a DS policy framework and implementation plan that will be right for consumers and the other stakeholders in Massachusetts' electricity market.

Respectfully Submitted,

MASSACHUSETTS DIVISION

OF ENERGY RESOURCES

By its attorney,

Anna Y. Blumkin

MASSACHUSETTS DIVISION

OF ENERGY RESOURCES

100 Cambridge Street, 15th Floor

Boston, MA 0220

(617) 727-4732

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